United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

ORIGINAL

77-7146

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 77-7146

DAVID GOLDBERG, suing derivatively in right and for the benefit of UNIVERSAL GAS AND OIL COMPANY, INC.,

Plaintiff-Appellant,

against

YAACOV MERIDOR, ET AL.,

Defendants-Appellees,

and

UNIVERSAL GAS & OIL COMPANY, INC.,

Nominal Defendant.

APPEAL FROM JUDGMENT OF UNITED STATES DISTRICT COURT
DISMISSING PLAINTIFF'S AMENDED COMPLAINT

UNITED STATES COURT OF APPEALS
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SECOND CIRCUIT

BRIEF FOR CERTAIN DEFENDANTS-APPELLEES

(SEE DESIGNATIONS BELOW)

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BRIEF FOR CERTAIN DEFENDANTS-APPELLEES

Preliminary Statement

Plaintiff-appellant David Goldberg, ("Goldberg") who instituted a derivative shareholders action on behalf of Universal Gas and Oil Company, Inc. ("UGO"), appeals from the judgment of the District Court entered March 4, 1977, dismissing, with prejudice, Goldberg's amended complaint for its failure to state a federal claim. This judgment also denied Goldberg leave to serve a third version of his complaint. (A-122)*.

As explained in the opinion of the District Court (Lasker, J.), 426 F. Supp. 1059 (1977), the amended complaint, which sought to allege a claim under Section 10 (b) of the Securities Exchange Act of 1934 (and Rule 10b-5 promulgated thereunder), was fatally defective in failing to allege deception, a necessary element of such a claim. In denying Goldberg's offer to further amend his complaint, so as to allege deception of UGO's minority shareholders, the District Court pointed out that Goldberg's claim was in reality a state law claim for which redress was available in the state courts and further noted that Goldberg in his previous two attempts had not even indicated how the deception of minority shareholders, which he wished to allege, had caused injury to UGO. (A-107).

Statement of the Case

In February, 1976, Goldberg commenced a shareholders' derivative action on behalf of UGO and against all of UGO's officers and directors, its parent corporation and

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* All such references to "A" followed by a number are to pages in the Joint Appendix.

others. This original Complaint asserted a single claim in favor of UGO based upon acts which, according to Goldberg's allegations, simultaneously violated the Securities Exchange Act of 1934 and New York State common law. (A-6).

The complaint specifically alleged the knowledge, complicity and participation by all of UGO's officers and directors in the alleged conspiracy and wrongdoings. (A-11).

UGO, the nominal defendant, moved to compel Goldberg to post security for UGO's costs and expenses under New York Business Corporation Law, Section 627. (A-17). That motion was granted on July 29, 1976. (A-35). The District Court's order held that UGO was entitled to security for costs and expenses, in an amount to be thereafter decided upon, unless Goldberg either amended his complaint to eliminate all state law claims, or complied with the requirements of the New York Business Corporation Law. Accordingly, Goldberg was given leave to amend his complaint.

Thereafter, on or about August 27, 1976, Goldberg served an amended verified complaint purportedly setting forth a single federal claim under Section 10 (b) of the Securities Exchange Act of 1934 (and Rule 10b-5 promulgated thereunder) and purportedly eliminating his state law claims. The amended complaint added eleven more individuals, one corporation and one accounting firm to the list of defendants, but except for some minor cosmetic changes, obviously made in an effort to eliminate all direct references to state law, the amended complaint contained the same substantive allegations as had the original complaint, including full knowledge, complicity and participation by UGO's officers and directors in the alleged wrongdoings. (A-42).

The gravamen of the original complaint and the amended complaint was a violation of state law—waste,

mismanagement and breach of fiduciary duty by UGO's officers and directors in conspiracy with others. Specifically, the amended complaint alleged that all of UGO's officers and directors caused an improper sale of certain UGO contracts; that they dissipated UGO's assets; that they agreed to an improvident asset for stock transaction; that the various transactions complained of had no business purpose or benefit to UGO, were not arm's length, were not fair and constituted breach by all of UGO's officers and directors of their fiduciary duty to UGO. Goldberg also made the false assertion that UGO is insolvent and in default on its obligations.

No allegation was made that action by UGO's shareholders was sought, obtained or needed in order to commence or complete any of these transactions.

Goldberg sought to sustain federal jurisdiction by alleging that these alleged violations of state law culminated in an unfair exchange by UGO of its shares for the assets of its parent, and, accordingly, that Section 10(b) and Rule 10b-5 were aplicable.

However, the Amended Complaint contained no meaningful allegation of deception or of causation. Believing that such allegations were necessary to state a claim under Section 10(b) and Rule 10b-5, and that none could be made since Goldberg had consistently alleged that UGO, through all of its officers or directors, knew of or participated in the wrongding, a majority of the defendants-appellees, joined by the nominal defendant UGO, moved to dismiss Goldberg's Amended Complaint for failure to state a claim. (A-56).

On February 10, 1977, Judge Lasker issued his opinion extensively analyzing the case law dealing with the need for deception in cases claiming a violation of Section 10(b). Although Judge Lasker's opinion was issued prior to the Supreme Court's decision in *Santa Fe Industries,*

Inc. v. *Green,* he concluded that deception was and had always been an indispensable element of a 10(b) claim and that the amended complaint was fatally defective in failing to allege such deception. Thereafter, on March 28, 1977, Judge Lasker issued a "correcting memorandum" pointing out that the Supreme Court's decision in *Santa Fe Industries, Inc.* v. *Green,* supported his earlier decision.

While Goldberg had offered to allege that UGO's minority shareholders had been deceived, Judge Lasker also refused Goldberg leave to again amend his complaint, Goldberg had already amended once, specifically in an effort to state a federal claim, and had yet to provide any indication as to how deception of minority shareholders was responsible for the injury to UGO. For this reason, and because Goldberg's claim was really a state law claim, fully capable of being vindicated in the state court, Judge Lasker, exercised his discretion so as to prevent this case from continuing to add to the increasing number of claimants seeking vindication for violations of state law in the federal courts.

It should also be pointed out that Goldberg did subsequently bring an action in New York State Supreme Court which is now pending.

Counter Questions Presented for Review

1. Do allegations of breaches of state law fiduciary duties and corporate waste in connection with an asset-for-stock transaction state a claim for relief under Rule 10b-5.

2. Did the Court abuse its discretion in refusing Goldberg leave to amend his complaint for a third time?

POINT I

The amended complaint does not allege deception in connection with the purchase or sale of securities cognizable under Rule 10b-5.

Goldberg brought this suit derivatively on behalf of UGO claiming that all the officers and directors of UGO, in a conspiracy with others, knowingly depleted UGO's assets through various acts of waste, mismanagement, and breach of fiduciary duties, including the exchange of UGO stock for assets of its parent, Maritimecor. Relying in the court below upon this Court's decision in *Green* v. *Santa Fe Industries, Inc.*, 533 F. 2d 1283 (1976), Goldberg claimed that deception was not a necessary part of his claim because the transaction depleting UGO's assets, was alleged to be inherently fraudulent. In fact, Goldberg frankly admitted that:

> "There was no one involved in this transaction, the sale of the UGO stock to its parent Maritimecor, to deceive. We claim that the directors and officers knew the facts as we allege them and participated in the fraud on UGO,"

and that deception of minority shareholders is not relevant here. (Plaintiff's Memorandum of Law in Opposition To The Motion To Dismiss and For Security For Costs, page 3).

The Supreme Court's subsequent reversal of this Court's decision in *Santa Fe* v. *Greene*, —— U.S. ——, 51 L.Ed. 2d 480, 97 S. Ct. —— (1977) understandably causes Goldberg to backpedal on this appeal. Goldberg now purports to find allegations of deception throughout his amended complaint. However, giving the amended complaint every favorable reading, the deception alleged, if there is any alleged, involves essentially an attack on the fairness of the transactions. Accordingly, as is set forth below, if

Goldberg's reasoning for this appeal were accepted, the decision of the Supreme Court in *Santa Fe* and the rationale behind it, would be emasculated, as would a whole line of other consistent decisions.

In *Santa Fe* minority shareholders brought a Rule 10b-5 action claiming undervaluation of their shares and lack of business purpose in connection with a Delaware short-form merger, all of which was allegedly not disclosed to minority shareholders. The Supreme Court emphasized the limitations on implying federal causes of action under Rule 10b-5 and held that deception, causally connected to a purchase or sale of securities, must be alleged to state a claim under Section 10 (b) of the Securities Exchange Act. Specifically excluded from the reach of Section 10 (b) are:

> "instances of corporate mismanagement . . . , in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary." 51 L.Ed. 2d at 494.

Goldberg's effort on this appeal to meet that standard, in effect, ignores it. Goldberg argues, circularly, that allegations that corporate officers and directors have failed to disclose their breaches of state law duty, somehow transforms a state law claim into a viable claim under Rule 10b-5. Although he concedes that no officer or director of UGO was deceived by the acts complained of (rather he alleged that each in fact was involved), Goldberg now suggests, that the directors' wrongdoing in allegedly dissipating the assets of the company "deceived" the minority shareholders.

Essentially, Goldberg is contending that, whenever corporate fiduciaries waste or mismanage or otherwise breach their state law duty, and a security is somehow involved, a traditional waste and mismanagement cause of action may be brought against them in a federal forum solely because they failed to disclose their wrongful acts. In virtually every case of corporate wrongdoing, the perpetra-

tors, quite naturally, "cover their tracks". If such a "cover-up" can convert a state action into a federal one, then plaintiffs can accomplish indirectly what *Santa Fe* prohibits directly.

The Supreme Court in *Santa Fe* set forth at length the factors which should be analyzed in assessing the sufficiency of a complaint under Rule 10b-5. First, the claim must fit strictly within the statutory language. Secondly federal claims should be implied only where necessary to fulfill the Congressional purpose underlying the adoption of the statute. Finally, federal courts should be

> "reluctant to federalize the substantial portion of the law of corporations that deals with transactions *in securities,* particularly where established state policies of corporate regulation would be overridden." *Id.* at 496. (emphasis added)

Goldberg's argument ignores each of these considerations, which clearly mandate dismissal of this claim. The Supreme Court obviously did not intend, in fact expressly proscribed, providing a federal forum wherever counsel is sufficiently clever to claim mismanagement was concealed. Accepting Goldberg's argument would render *Santa Fe* a meaningless matter of semantics.

The cases cited in footnote 15 of *Santa Fe* and relied upon here by Goldberg are plainly inapplicable. Initially, it should be noted that the Supreme Court in that footnote did not "approve", as Goldberg claims, in his brief (page 9), any of the decisions recited therein; that note merely stands for the proposition that no court prior to the Second Circuit decisions in *Green* v. *Santa Fe* and *Marshel* v. *AFW Fabrics* had gone so far as to dispense with the requirement of deception in a Section 10b action. The Court illustrated this fact by noting that each of the cases cited on appeal by Green had expressly found that someone was "deceived". An examination of the decisions cited by Goldberg from this footnote demonstrates this point.

In *Pappas* v. *Moss*, 393 F.2d 865 (3d Cir. 1968), deception of the minority shareholders was considered sufficient under Section 10b. There, however, deception of the minority shareholders was an essential causal link in the defendants' scheme. Although ratification by the Pappas shareholders of the conveyance of their corporation's stock for an allegedly inadequate consideration was not necessary under state law, the Third Circuit noted that the defendants' scheme envisioned and required the listing of that stock on the American Exchange. Shareholder approval was an important factor in obtaining that listing, and as the court pointed out, the resolution the shareholders were asked to ratify contained at least two material misrepresentations. *Id.* at 869. Thus, deception of those shareholders in order to induce certain action on their part was an essential causal link in the defendants' scheme. Here, no such "causal deception" of minority shareholders has been alleged.

The decision in *Shell* v. *Hensley*, 430 F.2d 819 (5th Cir. 1970), appears to have been a creature of estoppel. The complaint in *Shell* alleged that the defendants had gone to outrageous lengths to withhold the fact of their wrongdoing from the minority shareholders. Not only did the complaint allege that the defendants had sent out misleading proxy materials and reports, but it also alleged that the defendants had caused notices of a shareholders' meeting to be mailed in delayed fashion so as to preclude the minority from interfering in their fraud. *Id.* at 823. Since the defendants had manifested their desire, and the need, to deceive the minority shareholders, they were estopped from claiming that such deception was not necessary or that it had no causal connection to the harm being complained of.

This Court's decision in *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. 1968 en banc) dealt with a classic "manipulative device" which has been treated as virtually a per se violation of Section 10b, *i.e.*, trading on "inside

information". Essential to the decision was the manipulation of the market price of the corporation's stock by withholding clearly material information. No such manipulation is claimed, or could be claimed, here.

Plaintiffs' reliance upon *Zeller* v. *Bogue Electric Manufacturing Corp.*, 476 F.2d 795 (2d Cir. 1973) *cert. denied* 414 U.S. 908 (1973) and *Cochran* v. *Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1972) is confusing. In *Zeller*, the issues confronted by the court involved only what constitutes a "security" and the proper measure of damages. Although defendants had raised the absence of deception in the court below (346 F. Supp. 651 (S.D.N.Y. 1972)), the case had been dismissed in the court below on the erroneous basis that the corporation had suffered no damages. Neither court addressed the deception issue. *Cochran* was an action brought directly by a defrauded seller on the basis that defendants depressed the market price of his stock by reducing dividends. It clearly has no application to this derivative suit.

Finally, *Bailey* v. *Meister Brau Inc.*, 537 F.2d 982 (7th Cir. 1976) involved the majority stockholders' efforts to deny the single minority shareholder a contractual right of first refusal on sales of the corporation's stock. Continuing its liberal tendency in the securities area (see, e.g., *Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *rev'd, Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976)), the Seventh Circuit did express an inclination to include within Rule 10b-5 breaches of fiduciary duty. However, to the extent that *Bailey* or any of the other cases referred to stand for the proposition that a breach of fiduciary duty alone can constitute a federal cause of action, they are clearly overruled by *Santa Fe*.

Goldberg's attempt to fit this case to the situation involved in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971) and *Ruckle* v. *Roto*

American Corp., 339 F.2d 24 (2d Cir. 1964), by claiming that Mr. Siem, one of UGO's directors, was deceived, both goes beyond and distorts the record. First, it should be noted that the document upon which Goldberg builds his argument that Siem was deceived was not included in the Appendix. In addition, it is alleged in Goldberg's amended verified complaint that all of the "defendants engaged in the foregoing conduct and transactions with full knowledge of the aforesaid facts and with full knowledge of the falsity . . . of their statements." (A-50). Thus, the Court should ignore the argument altogether.

In any case, Mr. Siem never claimed that he was deceived in connection with any transaction involving UGO; rather, he claimed that he had not attended a board meeting for a substantial period of time and that he desired discovery to ascertain the status of the transaction complained of. In fact, Mr. Siem agreed to forego discovery on this point, which had been permitted by the lower court, after being informed that UGO had not, in fact, issued any of its shares to its parent. Thus, belated arguments concerning Mr. Siem's knowledge or lack thereof do not rise to allegations of deception, but at most, involve breaches of common law duties relating to the standard of performance for a director.

We respectfully submit that what Goldberg seeks is to litigate a "garden-variety" state law mismanagement and waste of corporate assets case in the federal courts. In doing so, he completely ignores the Supreme Court's holding in *Santa Fe* proscribing an extension of Rule of 10b-5 so as to "federalize" state corporate law. In the final analysis, no amount of circular reasoning or legal legerdemain can convert this state claim into a federal cause of action. As the Court below noted "both [Complaints] are prime examples of an attempt to fit the square peg of a state law claim into the round hole of a 10b-5 allegation." (A 118)

POINT II

Further Amendment of the Complaint is not Justified.

While plaintiff would seem to have a state cause of action, the conceded absence of deception of the officers and board of directors of UGO, through which the corporation acted, deprives plaintiff of any possibility of alleging a cause of action under Section 10(b) or Rule 10b-5. An amendment to allege deception of minority shareholders, the only amendment Goldberg indicated he was disposed to make, would not help, since deception could not have been causally connected to the alleged damage to UGO. Thus, while a further amendment of the complaint would result in considerable expense to the defendants and the consumption of additional judicial time and energy, it could not possibly succeed in converting plaintiff's state claim into a federal claim.

Plaintiff, represented by able and experienced counsel, has failed in his second attempt to set forth a federal cause of action. In wording the amended complaint, after defendants had successfully attacked the first complaint as being essentially a state cause of action, he was made "exquisitely aware" (A-118), of the need to state a federal claim. Under such circumstances, his failure to do so, even upon a most liberal reading of his allegations, shows that the deficiency is not one that could be cured by rewording or amending.

Appellant argues that the District Court should have permitted a further amendment of the complaint before dismissal and requests this Court to permit such amendment, if it is found that "the allegations of deception and nondisclosure were insufficiently pleaded" (Brief p. 13). In support of his position, appellant relies on the holding of *Schoenbaum* v. *Firstbrook, supra,* and *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F.2d 374 (2d Cir. 1974), *cert. denied,* 421 U. S. 976 (1975).

It is submitted that such reliance is misplaced for several reasons. First, in neither of the cited cases, contrary to the case at hand, had the appellant been given a prior opportunity to amend and correct his complaint. Secondly, the appellants in both the cited cases were found to have made allegations sufficient to support Section 10(b) and Rule 10b(5) causes of actions. Thirdly, and most importantly, neither case stands for the proposition that, if a plaintiff fails sufficiently and specifically to make allegations necessary to support a 10(b) and 10b-(5) claim, the Court should allow an amendment of such complaint prior to dismissal.

In essence, appellant is requesting this Court to give him a third bite of the proverbial apple of justice. The reason appellant has twice failed to produce a sufficient pleading is simply that the facts of the transaction complained about do not include any causally connected deception and therefore cannot constitute 10(b) and 10b-(5) violations. As Judge Lasker very succinctly stated in his opinion at A-118:

> "There is a limit to the time and energy a federal court should accord to marginal causes of action which are fully capable of being vindicated in state court. Presumably, if the element of deceit formed any significant aspect of Goldberg's claim, or was responsible for the alleged injury to UGO, Goldberg could have been expected to have plead such facts before the third go around."

This Court has long held that amendment after dismissal of a complaint lies in the sound discretion of the district judge. *Swan* v. *Board of Higher Education of the City of New York,* 319 F. 2d 56 (2d Cir. 1963). See also *Christophides* v. *D. A. Porco, et al.,* 289 F. Supp. 403 (S.D.N.Y. 1968). In *Stephenson* v. *Landegger et al.,* 464 F. 2d 133 (2d Cir. 1972), *cert. denied,* 409 U. S. 1039, this court held at page 135.

> "The next essential issue is the propriety of Judge

> Tenney's dismissal of the action rather than granting leave to amend. This is a determination traditionally left to the sound discretion of the district judge. While the exercise of such discretion is reviewable, we will not intefere absent a clear showing of abuse."

In the case at hand, clearly there was no abuse of discretion. In fact, Judge Lasker rendered every accommodation to appellant in order to allow him an ample opportunity to plead a federal cause of action, which he cannot do. Under the circumstance, appellant's request for a third opportunity to make a sufficient pleading should be denied.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the District Court's decision below should be affirmed and Goldberg's appeal should be dismissed.

Respectfully submitted,

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UNIVERSAL OIL & GAS COMPANY, INC.,

Nominal Defendant.

State of New York,
County of New York,
City of New York—ss.:

IRVING LIGHTMAN , being duly sworn, deposes and says that he is over the age of 18 years. That on the 27th day of May , 1977, he served two copies of Brief for Certain Defendants-Appellees on Turchin & Topper, Esqs. , the attorney s for Plaintiff-Appellant by delivering to and leaving same with a proper person in charge of their office at 60 East 42nd Street in the Borough of Manhattan , City of New York, between the usual business hours of said day.

Irving Lightman

Sworn to before me this
27th day of May , 1977.

Courtney J. Brown

COURTNEY J. BROWN
Notary Public, State of New York
No. 31-5472920
Qualified in New York County
Commission Expires March 30, 1978

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